VZCZCXRO0588
PP RUEHCN RUEHGH
DE RUEHHK #2094/01 1391039
ZNY CCCCC ZZH
P 191039Z MAY 06
FM AMCONSUL HONG KONG
TO RUEHC/SECSTATE WASHDC PRIORITY 6784
INFO RUEHOO/CHINA POSTS COLLECTIVE
RUCPDOC/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

C O N F I D E N T I A L SECTION 01 OF 04 HONG KONG 002094

SIPDIS

SENSITIVE
SIPDIS

STATE FOR EAP/CM AND EB
TREASURY FOR DAS DOHNER/KOEPKE
USDOC FOR 4420
USDOC FOR DAS LEVINE AND ITA/MAC/AP/MCQUEEN
MANILA FOR ADB/USED AMBASSADOR SPELTZ
STATE PASS USTR
STATE PASS CEA FOR BLOCK
STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON/SCHINDLER; SAN
FRANCISCO FRB FOR CURRAN/LUNG; NEW YORK FRB FOR
DAGES/CLARK/MOSELEY
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN

E.O. 12958: DECL: 05/19/2031
TAGS: EFIN ECON HK CH
SUBJECT: BANK OF CHINA GOING PUBLIC IN A VOLATILE MARKET

REF: 05 HONG KONG 4858

Classified By: EP Chief Simon Schuchat; Reasons: 1.4 (b/d)

SUMMARY

¶1. (C) SUMMARY: In a financial history milestone for both Hong Kong and the mainland, the Bank of China (BOC) is going public. The USD 10 billion initial public offering (IPO) now underway will almost certainly be the world's biggest this year and the largest ever for Hong Kong. The high degree of enthusiasm for the IPO -- carefully cultivated with sales of strategic stakes to foreign investors and culminating now with thousands of Hong Kongers lining up to get a piece of the action -- appears immune to what is otherwise the sharpest short-term downturn in recent memory for Hong Kong's stock market. Last year, two of China's five largest banks, China Construction Bank and Bank of Communications, went public in Hong Kong, and another of China's large lenders, the International Commercial Bank of China (ICBC), is expected to list here shortly, perhaps this fall. The listing process has served as a catalyst for all of these banks to clean up balance sheets, upgrade internal controls, and modernize operations, all while helping Hong Kong rise to the position of the world's fourth-ranked capital raising center. BOC will also issue stock in Shanghai, but the number of shares in that market will be far less than what is placed in Hong Kong. The motive for even selling shares at all in Shanghai appears to be political, in the view of head of Hong Kong's Securities and Futures Commission (SFC). Although China appears to have found a successful formula for selling state banking assets through strategic sales that then give credibility to follow-on IPOs, there are critical voices in this regard: some who suggest that foreigners will be disappointed when the true scope of China's banking problems emerges and others who believe the Chinese government is selling off valuable and strategic assets at unacceptably low prices. END SUMMARY

HUGE LISTING

¶2. (U) BOC's stock will start trading in Hong Kong on June ¶1. By that time, between 10.5 and 12 percent of the bank will be in the public's hands, and in return BOC will have raised USD 10-12 billion in what will be almost certainly be the top IPO in the world this year, the biggest ever conducted in Hong Kong, and perhaps the fourth largest in global financial history. Although Hong Kong's stock market has fallen by more than 6 percent since its recent May 8 peak, the success of BOC's IPO does not appear in question, as is evidenced by the thousands of people lining up all over Hong Kong to get a piece of the action. These investors are motivated in part by the very high post-IPO returns enjoyed by investors in two mainland banks that went public here last year -- China Construction Bank (48 percent appreciation) and Bank of Communications (81 percent appreciation).

A LONG TIME IN COMING

¶3. (U) BOC is China's oldest bank, dating to 1912, and has historically played the role of the PRC's state-directed international finance arm, holding a monopoly on foreign exchange dealings and international banking from 1949 to ¶1994. Like China's other large state-run banks, BOC evolved into a channel for funneling the public's savings into inefficient state-owned enterprises, ultimately resulting in very high non-performing loan (NPL) levels. The bank has also been slow to develop internal credit risk assessment capabilities and has suffered from a string of malfeasance cases including the jailing of Wang Xuebing, its president from 1994 to 2000, for taking bribes.

¶4. (U) China has in recent years injected significant funds into cleaning up bank balance sheets with an eye towards

making its banks capable of competing when the domestic retail banking market opens up at year-end, in accordance with WTO membership commitments. In BOC's case, the Chinese government supplied USD 22.5 billion of foreign reserves in 2003 to help it cover delinquent loans. Media reports that BOC's NPL ratio declined from 22 percent in 2003 to 4.9 percent in 2005. (Note: Earlier this month, Ernst & Young estimated that the Chinese financial system might have up to USD 900 billion in bad bank loans compared with a recent official estimate of USD 164 billion. Ernst & Young retracted the report after it drew a sharp rebuke from the Chinese government. End Note)

¶5. (SBU) In 2002, BOC's Hong Kong operations -- now a subsidiary and separate entity known as BOCHK -- were consolidated and the company was taken public. BOCHK, with USD 22 billion in market capitalization, ranks third among mainland enterprises incorporated and listed here ("Red Chips"). The bank has had its share of transition pains, malfeasance cases, and organizational reshuffles and now, according to our contacts there, sees itself as a multinational bank with a culture much more focused on cultivating a reputation for international grade internal controls.

¶6. (U) After the dust settled from the BOCHK launch, BOC began selling single-digit strategic stakes of itself to large foreign investors, with RBS, Temasek, UBS, the Li Ka-shing Foundation, Merrill Lynch, and the Asian Development Bank all buying in. This was an important step in generating confidence in BOC's future in advance of the IPO. An additional twelve corporate investors then made advance commitments to buying actual portions of the IPO, laying the groundwork for what is apparently going to be a very successful listing.

SHANGHAI NEXT -- BUT IS IT POLITICAL?

¶7. (C) Because of the PRC's capital controls, mainland firms

that go public either come to Hong Kong to market themselves to foreign investors and raise foreign exchange or go to Shanghai/Shenzhen to tap domestic investors and get renminbi. Hong Kong shares trade freely, are denominated in a convertible currency, and are placed on the market in accordance with strict listing standards, applied thoroughly yet efficiently. Shanghai has over time demonstrated a less rigorous and less efficient listing process, and the exchange has faced difficulties because of corporate governance issues and as a result of the overhang created by a high proportion of government holdings in listed shares. Reforms now underway, including efforts to address the government holdings issue, have gained traction, and the exchange has just recently signaled its willingness to host new listings.

¶8. (C) SFC Chairman Martin Wheatley told us on May 18 that there is growing sensitivity among the mainland public about the inability to access good investment opportunities involving quality mainland companies, which often list only in Hong Kong. He observed that after Hong Kong, BOC will have a smaller listing in Shanghai. In the view of Wheatley and one of his subordinates elaborating on the issue, listing in Shanghai is a political necessity in the context of that exchange's reform process rather than reflective of a need to raise renminbi. BOC's Chairman Xiao Gang recently announced that the combined listings in Hong Kong and Shanghai will amount to 15 percent of shares, implying that the Shanghai tranche will be 3 to 4.5 percent of BOC's ownership, depending on whether high demand in Hong Kong triggers an enlargement of the listing here from 10.5 to 12 percent, considered likely.

NOT THE FIRST ONE

¶9. (C) The Bank of Communications (BoCom), China's fifth largest bank, went public in June 2005 and was the first Chinese domestic bank to list here, raising approximately USD

2 billion in a highly successful IPO. HSBC had purchased a 19.9 percent stake in the bank the previous year. China Construction Bank (CCB), China's third largest bank by assets, raised USD 9.2 billion in October 2005 by selling off 12 percent of itself in Hong Kong. CCB was the first of the "big four" Chinese banks to go public. The strong reception for the IPO was viewed by analysts here as a vote of confidence not only in prospects for China's economy to maintain feverish growth without a hard landing but also in the ability of state-run Chinese banks to clean up their balance sheets, reform their lending practices, and manage themselves in a manner that will create value for foreign investors. CCB's IPO was bolstered by strategic investments already made in the bank by Bank of America (USD 3 billion, 9.9 percent stake) and Singapore's state-affiliated Temasek Holdings (USD 2.4 billion, 5.1 percent stake).

WIN-WIN, WIN-LOSE, OR LOSE-LOSE?

¶10. (C) Taken together, the experiences of BOCHK, BoCom, CCB, and BOC, suggest that the mainland has found a formula for drawing foreign ownership into its large banks at a rewarding price. But there are some observers who feel otherwise. CLSA Managing Director Jim Walker recently told us that with the exception of the HSBC-BoCom deal, all other strategic stakes taken by foreign commercial banks are likely to turn out disappointing, given internal management and loan quality problems that have yet to become apparent. BOCHK Senior China Economist Michael Dai commented to us that recent high rates of lending by the big mainland banks lower their apparent NPL rates and make them look more attractive to investors -- yet these new loans are often in sectors like property and construction where there is much risk ahead, so a new batch of balance sheet problems may lie down the road. (Note: Dai very explicitly said that he was unable to comment

specifically on the BOC IPO given his employment with a subsidiary; his comment should be read as general in nature. End Note) Others feel that valuable state assets are being sold too cheaply to foreigners. After all, strategic stake sales and IPOs are giving people outside the mainland a chance to buy into a rapidly growing market of USD 4 trillion of assets held by a population with fast-growing incomes and which is increasingly interested in borrowing money and using a broad array of banking services. Such skepticism about under-pricing of assets in transactions with foreigners emerged at the National People's Congress meeting in March.

HONG KONG AS A LISTING CENTER

¶11. (U) "Going public" for mainland firms in Hong Kong involves issuing two kinds of shares here, both well known to China-oriented investors: "H-shares" are stocks of Chinese-incorporated firms that trade in Hong Kong, such as PetroChina, China Life Insurance, and Air China; Red Chips are stocks of Hong Kong-based corporations that are substantially owned by entities affiliated with the Chinese government, including Lenovo and China Mobile. BOC will be an H-share; BOCHK is a Red Chip.

¶12. (U) The issuance of shares by Red Chip and H-share companies has, since 1993, raised over USD 140 billion in funds and created over USD 450 billion of market capitalization, 40 percent of the Hong Kong stock market's total, representing a range of key sectors. This in turn has provided significant volumes of cash to refine or expand the business operations of major Chinese corporations (whose activities, depending on the firm, are both domestic and foreign) by attracting portfolio investment from foreign shareholders via Hong Kong. The Hong Kong stock market ranked fourth in the world last year for equity fund-raising (after New York, Toronto, and the Spanish Exchanges) and eighth overall for market capitalization.

PLATEAU COMING?

¶13. (C) BOCHK's Dai said that once ICBC lists, the era of large mainland IPOs in Hong Kong may start to wane. SFC's Wheatley echoed Dai, adding that there is some tension and heightened competition now between Hong Kong and Shanghai because the latter is increasingly interested in attracting blue chip firms. That said, Beijing wants to keep Hong Kong a strong financial center to take advantage of the high degree of confidence in the city's legal system and reputation for relatively strong corporate governance. Wheatley predicted that while there may be fewer blockbuster IPOs coming down the pike, the Hong Kong exchange is unlikely to look beyond Hong Kong and the mainland for a new source of listings business any time in the near future.

Cunningham